MANAGER'S BUDGET ADDENDUM #37

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Larry D. Lisenbee

SUBJECT: GENERAL FUND EXPENDITURES GROWING FASTER THAN PROJECTED REVENUES

DATE: June 7, 2007

Approved /s/ Date 06/08/07

BACKGROUND

This memorandum is prepared in response to the Mayor's March Budget Message for 2007-2008 which directed the administration to identify all elements of General Fund projected expenditures that are growing faster than projected revenues.

ANALYSIS

To address this referral, the 2008-2012 General Fund Five-Year Forecast, which was released in February 2007, was analyzed to compare the projected growth rates of revenues and expenditures to determine which expenditure categories are expected to experience a rate of growth that outpaces revenue growth. On an overall basis, in each of the next five years, expenditure growth is projected to exceed revenue growth. As shown in the table below, the projected average total growth rate in revenues of 3.66% is not sufficient to meet the projected total expenditure growth rate of 4.52%.

2008-2012 General Fund Forecast
Projected Revenue and Expenditure Growth

	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
Revenue % Growth*	2.97%	4.11%	3.80%	3.74%	**3.66%**
Expenditure % Growth**	5.31%	4.80%	3.81%	4.15%	**4.52%**

* Excludes Beginning Fund Balance. Assumes continuation of the Emergency Communication System Support Fee (ECSS) in 2010-2011. Actual 2008-2012 General Fund Forecast document published for that year actually reflects 0.90% growth due to the assumption of an ECSS Fee Sunset.

** Includes Committed Additions (expenses associated with maintaining and operating new public facilities)

When the expenditure trends were broken out and analyzed by category, as summarized in the table below and discussed in detail in Attachment A, it was determined that half of the expenditure categories (Personal Services, Capital Projects, Contingency Reserve, and Committed Additions) have projected average growth rates that exceed the average revenue growth rate over the next five years. The remaining expenditure categories (Non-Personal/Equipment, City-Wide Expenses, Transfers, and Earmarked Reserves) have projected average growth rates that are below the average revenue growth rate over that same period.

2008-2012 General Fund Forecast
Comparison of Projected Revenue and Expenditure Growth by Category

	2008-2009	2009-2010*	2010-2011	2011-2012	Average Growth
Revenue Growth	2.97%	4.11%	3.80%	3.74%	**3.66%**
Expenditure Categories Growing Faster Than Revenue Growth					
Personal Services	5.45%	4.38%	4.41%	4.43%	**4.67%**
Capital Projects	48.49%	0.60%	3.92%	3.77%	**14.12%**
Contingency Reserve	4.80%	4.36%	3.47%	3.80%	**4.11%**
Committed Additions	231.21%	82.47%	49.78%	9.46%	**93.23%**
Expenditure Categories Growing Slower Than Revenue Growth					
Non-Personal/Equipment	0.00%	6.21%	(1.04%)	3.41%	**2.15%**
City-Wide Expenses	2.59%	2.04%	2.07%	2.15%	**2.21%**
Transfers	4.15%	0.00%	(8.20%)	2.59%	**(0.37%)**
Earmarked Reserves	0.00%	0.00%	0.00%	0.00%	**0.00%**

As expected, our analysis indicates that Personal Services costs, which account for approximately two-thirds of the General Fund Budget, are the largest factor driving expenditure growth to levels exceeding revenue growth rates, and is therefore the primary driver of the forecasts for continued shortfalls for the next few years in the Forecast. In the Forecast, Personal Services costs are broken down into three major components (Salaries and Other Compensation, Retirement, and Health and Other Fringe Benefits). Factors that impact this expenditure category include scheduled step increases, negotiated salary cost-of living and benefit adjustments, and retirement plan actuarial studies. The Committed Additions line item deals with the additional operating maintenance cost obligations associated with in progress or planned capital improvement projects (e.g. Fire Stations, Branch Libraries, Park Community Centers). This category is the second most significant driver, at least for the next four years, of continued shortfall projections. With the addition of new libraries, community centers, and public safety facilities funded by General Obligation Bonds, the Committed Addition line item reflects significantly larger growth than would typically be anticipated. Once the General Obligation

Bond projects are completed, the growth rate in this category is expected to decline significantly. Since the Contingency Reserve is calculated at 3% of projected General Fund expenditures, this category will exceed the projected revenue growth as long as the overall expenditures are exceeding revenue growth. The last four categories (Non-Personal/Equipment, City-Wide Expenses, Transfers, and Earmarked Reserves) are expected to growth at a slower rate than revenue growth, helping to partially offset the impact of those expenditure categories that are growing at a faster rate.

Additional detail on each expenditure category is provided in Attachment A, including the growth by fiscal year, the average growth over the five-year period, a brief discussion of the assumptions that were used in the development of the 2008-2012 General Fund Forecast, and the identification of key drivers in particular expenditure categories.

As discussed in the 2008-2012 General Fund Forecast, caution is in order when considering the significance of the revenue and expenditure projections. Given the decreasing level of precision to be expected in the later years of a multi-year forecast, the projections in the out years should be considered in terms of the relative size of the decrease or increase from the prior year. This information helps provide a multi-year perspective to budgetary decision-making and identifies trends. It should not, however, be considered a precise prediction of what will occur. The assumptions in the out-years of the forecast will be thoroughly analyzed and updated for the preliminary forecast that will be released next fall and the final 2009-2012 Forecast that will be released in winter 2008.

/s/
LARRY D. LISENBEE
Budget Director

Attachment

ELEMENTS OF THE BASE GENERAL FUND FORECASTED REVENUES AND EXPENDITURES

The following data from the 2008-2012 General Fund Five-Year Forecast was used to compare the projected growth rates of revenues and expenditures to determine which expenditure categories are expected to experience a rate of growth that outpaces revenue growth. The projected revenue and expenditure growth by year, the average growth over the five-year period, and a discussion of each expenditure category are provided below.

GENERAL FUND REVENUES

As shown in the table below, General Fund revenues are expected to increase an average of 3.66% per year over the next five years.

2008-2012 General Fund Forecast
Revenue Growth
(Excludes Beginning Fund Balance)

2007-2008	2008-2009	2009-2010*	2010-2011	2011-2012	Average Growth
779,748,000	802,872,000	835,875,000	867,638,000	900,088,000	
% Growth	**2.97%**	**4.11%**	**3.80%**	**3.74%**	**3.66%**

* Assumes continuation of the Emergency Communication System Support Fee (ECSS).

GENERAL FUND EXPENDITURES

Expenditure growth, as shown in the table below, is expected to increase an average of 4.52% per year over the next five years. In each year of the Forecast, expenditure growth is projected to exceed revenue growth.

2008-2012 General Fund Forecast
Expenditure Growth
(Includes Committed Additions)

2007-2008	2008-2009	2009-2010*	2010-2011	2011-2012	Average Growth
846,957,000	891,909,000	934,704,000	970,309,000	1,010,608,000	
% Growth	**5.31%**	**4.80%**	**3.81%**	**4.15%**	**4.52%**

General Fund Expenditures can be broken down into several broad categories. These categories include: Personal Services, Non-Personal/Equipment, Capital Projects, City-Wide Expenses, Transfers, Earmarked Reserves, Contingency Reserve and Committed Additions. The categories in which expenditure growth is projected to exceed revenue growth include: Personal Services, Capital Projects, Contingency Reserve, and Committed Additions. Following is a discussion of each category, broken down by those in which expenditure growth is projected to grow faster than revenue growth and those in which expenditure growth is projected to growth slower than revenue growth.

GENERAL FUND EXPENDITURES (CONT'D.)

Expenditure Categories Growing Faster Than Revenue Growth

Personal Services

2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
614,127,000	647,610,000	675,988,000	705,768,000	737,029,000	
% Growth	**5.45%**	**4.38%**	**4.41%**	**4.43%**	**4.67%**

In the 2008-2012 Five-Year Forecast, Personal Services costs increase from $614.1 million in 2007-2008 to $737.0 million in 2011-2012, for an average growth rate of 4.67%. In our system, Personal Services costs are broken down into three major components (Salaries and Other Compensation, Retirement, and Health and Other Fringe Benefits).

In the Forecast, *Salaries and Other Compensation and Retirement* costs are adjusted for scheduled step increases and anticipated negotiated salary cost-of-living (COLA) and benefit adjustments. The actual average growth rate for step increases in 2007-2008 is projected to be 1.3%. As required by our civil service rules, step increases are provided for non-management employees annually who have not reached the top step in their classification. All four out years of the forecast include this projected 1.3% increase. In addition, assumptions for negotiated salary compensation and benefit increases and assumptions for future increases have been included.

Retirement costs in the Forecast have only been adjusted for the impact of step increases and COLAs. Every two years, an actuarial study is completed on the City's two retirement systems, Federated and Police and Fire. The latest actuarial studies were completed in 2005-2006 and new rates were implemented for 2006-2007 and 2007-2008. The Police and Fire Retirement Plan was updated in 2006-2007 to reflect the impact of increased benefits negotiated for members of the San José Police Officers Association. Actuarial studies are expected in 2007-2008 to develop revised retirement contribution rates, effective in 2008-2009 and 2009-2010. Due to the volatility of retirement rates, however, no retirement rate contribution adjustments for this biennial activity have been assumed during this forecast period. As an indication of how volatile rates are in this category, Federated Retirement rates decreased 12.6% in 2002, increased 12.6% in 2004 and increased 28.4% in 2006. Police and Fire Retirement rates decreased 9.4% in 2002, increased 72.9% in 2004 and increased 2.6% in 2006.

Health and Other Fringe Benefit cost increases have been projected in each year of the Forecast. In 2007-2008, a 12% increase to the City's contribution for employee health care has been assumed. An 11% increase in each of the remaining four out years of the 2008-2012 Forecast has also been included. In the Other Fringe Benefits category (dental, unemployment insurance, employee assistance program), an annual increase of 4% is assumed in all forecast years. These increases include the continuation of the cost-sharing formulas already implemented for health and dental benefits.

GENERAL FUND EXPENDITURES (CONT'D.)

Expenditure Categories Growing Faster Than Revenue Growth (Cont'd.)

Capital Projects

2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
3,914,000	5,812,000	5,847,000	6,076,000	6,305,000	
% Growth	**48.49%**	**0.60%**	**3.92%**	**3.77%**	**14.12%**

The Capital Projects category increases from $3.9 million in 2007-2008 to $6.3 million in 2011-2012, for an average growth rate of 14.12%. The large increase in 2008-2009 reflects the assumption that the General Fund will resume paying the debt service for Central Service Yard Phase I and the annual contribution to the Fire Apparatus Replacement and Repair line item. These items have been supported by other funding sources in recent years as a budget-balancing strategy. Factoring out that adjustment, the growth in this category is very close to the projected revenue growth. In years 4 and 5 of the Forecast, it is also assumed that an additional $200,000 annually will be necessary to support the Fire Apparatus Replacement and Repair project in order to provide sufficient resources to meet the replacement schedules for fire apparatus.

Contingency Reserve

2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
27,290,000	28,599,000	29,846,000	30,883,000	32,057,000	
% Growth	**4.80%**	**4.36%**	**3.47%**	**3.80%**	**4.11%**

The Contingency Reserve category increases from $27.3 million in 2007-2008 to $32.1 million in 2011-2012, for an average growth rate of 4.11%. Per City Council policy, the Contingency Reserve is projected at the level necessary to comply with the City Council policy to maintain a 3% Contingency Reserve. Growth is this category will mirror growth in the remaining expenditure categories.

Committed Additions

2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
2,150,000	7,121,000	12,994,000	19,463,000	21,305,000	
% Growth	**231.21%**	**82.47%**	**49.78%**	**9.46%**	**93.23%**

Committed additions include those expenditures to which the City is considered to be committed by previous Council direction and has less, or in some cases no discretion, such as debt service payments and operating and maintenance costs for capital projects scheduled to come on-line during the forecast period. Committed Addition costs are projected to increase from $2.2 million in 2007-2008 to $21.3 million in 2011-2012. This includes the expenses associated with new street improvements, parks, community centers, libraries, and public safety facilities. With the approval of the parks and recreation, library, and public safety bond measures, there has been a significant increase in the number of new facilities coming on-line. Once the bond projects are completed, growth in this category is expected to decline significantly.

GENERAL FUND EXPENDITURES (CONT'D.)

Expenditure Categories Growing Slower Than Revenue Growth

Non-Personal/Equipment

2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
90,604,000	90,618,000	96,254,000	95,258,000	98,508,000	
% Growth	**0.00%**	**6.21%**	**(1.04%)**	**3.41%**	**2.15%**

In the 2008-2012 Forecast, Non-Personal/Equipment costs increase from $90.6 million in 2007-2008 to $98.5 million in 2011-2012, for an average growth rate of 2.15%. While the overall growth rate in this category is below the average rate of revenue growth, there are several elements that are very volatile. These include the replacement of the police fleet, vehicle maintenance and operations costs, and gas and electricity costs. Replacement schedules for the marked, covert and unmarked Police fleet range in the five-year period from an increased need of $2.0 million in 2009-2010 to a reduced need of $1.8 million in 2008-2009. The costs to maintain and operate the City's fleet have risen dramatically due to the current volatility in the cost of fuel. Gas and electric costs to heat and cool City facilities are projected to increase at rates greater than revenue growth during the forecast period.

City-Wide Expenses

2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
77,845,000	79,858,000	81,488,000	83,176,000	84,964,000	
% Growth	**2.59%**	**2.04%**	**2.07%**	**2.15%**	**2.21%**

In the 2008-2012 Forecast, City-Wide Expenses costs increase from $77.8 million in 2007-2008 to $85.0 million in 2011-2012, for an average growth rate of 2.21%. Even though overall this category's rate of growth is below the rate of revenue growth, there are three significant elements of this category that have been projected to grow at a level greater than the average growth rate for revenues. These include Workers' Compensation Claims Payments, Sick Leave Payments Upon Retirement and Debt Service Payments for FMC Property. Workers' Compensation Claims Payments range from $16.4 million in 2007-2008 to $20.3 million in 2011-2012. A portion of these cost increases is directly tied to the cost increases for salary compensation. The remainder of these cost increases is linked to the rising costs within the health care industry. Sick Leave Payments Upon Retirement expenditures have been included at $8.2 million in 2007-2008 and increase to $9.6 million in 2011-2012. These payments are also directly tied to the increases assumed for salary compensation increases. Debt Service Payments for FMC are $7.4 million in 2007-2008 and increase to $7.8 million in years 2 through 5 to reflect the actual debt service payment schedule.

GENERAL FUND EXPENDITURES (CONT'D.)

Expenditure Categories Growing Slower Than Revenue Growth (Cont'd.)

Transfers

2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
30,477,000	31,741,000	31,737,000	29,135,000	29,890,000	
% Growth	**4.15%**	**0.00%**	**(8.20%)**	**2.59%**	**(0.37%)**

In the 2008-2012 Forecast, Transfer costs, whose payments are generally determined by separate schedules unrelated to the growth of revenues or other expenditures in the General Fund, decrease from $30.5 million in 2007-2008 to $29.9 million in 2011-2012. There are three significant adjustments in this category over the forecast period: San José Arena Management Agreement capital costs, debt service payments for the City Hall Employee Parking Garage, and completion of debt service payments for the Communications Center. Per the existing agreement with the San José Arena Management, two transfers totaling $1.25 million annually ($750,000 to the Arena Reserve Fund and $500,000 to the Arena Enhancement Fund) are required beginning in 2008-2009. The transfer to the City Hall Debt Service Fund in 2007-2008 is $18.8 million and is projected to increase to $20.8 million in years 2 through 4, which is a 10% increase in that line item in year 2. This increase is due to the annualization of the debt service payment for the employee parking garage. Offsetting these increases is the elimination of the transfer for the Communications Center Debt Service Payment. The final debt service payment for the Communications Center of $2.4 million is scheduled in 2009-2010.

Earmarked Reserves

2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	Average Growth
550,000	550,000	550,000	550,000	550,000	
% Growth	**0.00%**	**0.00%**	**0.00%**	**0.00%**	**0.00%**

In the 2008-2012 Forecast, Earmarked Reserve costs remain at $550,000 throughout the five years. These costs include an allocation for the Comprehensive General Plan Update ($200,000), which is entirely offset by revenues collected from a surcharge on development permits, and allocations for Equipment ($100,000) and Computer Equipment and Automation Projects ($250,000) for subsequent allocation during the Proposed Budget process.